

**THE OFFICE OF REGULATORY STAFF
DIRECT TESTIMONY AND EXHIBITS
OF
SHARON G. SCOTT**

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**DOCKET NO. 2004-357-W/S
APPLICATION OF
CAROLINA WATER SERVICE, INC.
FOR ADJUSTMENT OF
RATES AND CHARGES**

TESTIMONY OF SHARON G. SCOTT**FOR****THE OFFICE OF REGULATORY STAFF****DOCKET NO. 2004-357-W/S****IN RE: CAROLINA WATER SERVICE, INC.**

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.

A. My name is Sharon G. Scott. My business address is 1441 Main Street, Suite 300, Columbia, South Carolina, 29201. I am employed by the Office of Regulatory Staff as an Auditor.

Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND YOUR BUSINESS EXPERIENCE.

A. I received a B.S. Degree in Business Administration, with a major in Accounting from the University of South Carolina in May 1983 and a MBA degree from Webster University in May 2000. I was employed by the South Carolina Public Service Commission in July 1983 and have participated in cases involving gas, electric, telephone, water and wastewater utilities. I have over 21 years of experience auditing utility companies. In January 2005, I began my employment with the Office of Regulatory Staff (ORS).

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY INVOLVING CAROLINA WATER SERVICE, INC?

1 A. The purpose of my testimony is to set forth my findings and recommendations
2 resulting from ORS's review of the application of Carolina Water Service, Inc.
3 (CWS) in this docket.

4 **Q. PLEASE IDENTIFY THE EXHIBITS ATTACHED TO YOUR PREFILED**
5 **TESTIMONY.**

6 A. I have attached ORS's Audit Report related to CWS's Application for a Rate
7 Increase, Docket No. 2004-357-W/S. The contents of the Audit Report were either
8 prepared by me or were prepared under my direction and supervision in compliance
9 with recognized accounting and regulatory procedures for Water and Wastewater
10 utility rate cases.

11 **Q. PLEASE EXPLAIN THE CONTENTS OF THE AUDIT REPORT.**

12 A. As outlined in the Index of the Audit Report, pages 1-5 contain the analysis of CWS
13 and its application. The remaining pages consist of exhibits which were prepared to
14 show various aspects of CWS's operations and financial position. The majority of
15 my testimony will refer to Audit Exhibit SGS-1 - Operating Experience, Rate Base
16 and Rates of Return -- Combined Operations as shown on page 6 of the Audit Report.

17 **Q. PLEASE DESCRIBE THE FORMAT OF AUDIT EXHIBIT SGS-1.**

18 A. Column (1) shows per book balances for CWS as of June 30, 2004. I verified the per
19 book balances to the books and records of CWS.

20 Column (2) shows my accounting and pro forma adjustments designed to normalize
21 CWS's per book operations.

1 Column (3) shows my computation of CWS's normalized test year prior to
2 implementing the proposed increase.

3 Column (4) shows the adjustments for the requested rate increase and ORS's
4 adjustments associated with the additional revenues.

5 Column (5) shows our computation of the normalized test year after accounting and
6 pro forma adjustments, the requested rate increase and associated adjustments.

7 **Q. PLEASE ELABORATE ON THE CALCULATIONS IN AUDIT EXHIBIT**
8 **SGS-1 – OPERATING EXPERIENCE, RATE BASE AND RATES OF**
9 **RETURN - COMBINED.**

10 A. Column (1) shows the per books operating experience of CWS. We computed Total
11 Income for Return of \$908,668 based on Total Operating Revenues of \$5,644,690
12 less Total Operating Expenses of \$4,753,778 and added per book Allowance for
13 Funds Used During Construction (AFUDC) of \$17,756. Per Book Total Rate Base
14 amounted to \$15,639,930. As shown in the application, CWS computed the per book
15 rate of return of 5.70% using Net Operating Income of \$890,912 and Total Rate Base
16 of \$15,639,930.

17 In Column (2) our accounting and pro forma adjustments are presented to normalize
18 CWS's test year operations. A description of each adjustment is contained in Audit
19 Exhibit SGS- 4.

20 Column (3) is the sum of Columns (1) and (2) and reflects the As Adjusted figures.

21 The accounting and pro forma adjustments produced Net Income for Return of

1 \$547,474 and Total As Adjusted Rate Base of \$14,770,115, resulting in a Rate of
2 Return on Rate Base of 3.71%.

3 Column (4) shows the effect of the proposed increase as requested by CWS. These
4 adjustments are detailed in Audit Exhibit SGS – 4.

5 Column (5) shows per book operations, adjusted for accounting and pro forma
6 adjustments and the requested increase. Using Total Operating Revenues of
7 \$7,476,043 less Total Operating Expenses of \$5,780,459 and adding Customer
8 Growth of \$25,134, I computed Net Income for Return of \$1,720,718. Net Income
9 for Return of \$1,720,718 divided by Total Rate Base of \$14,770,115 produced a Rate
10 of Return on Rate Base of 11.65%.

11 **Q. PLEASE EXPLAIN THE ADJUSTMENTS IN AUDIT EXHIBIT SGS - 4.**

12 **A.** The adjustments are as follows:

13 Adjustment No.1 - The Water/Wastewater Department proposes to adjust the
14 revenues using billing information for the test year ended June 30, 2004. Dawn Hipp
15 provided me with the results of the bill frequency analysis. The As Adjusted Service
16 Revenues computed by the Water/Wastewater Department totaled \$5,610,597 less
17 the per book amount of \$5,580,732, for an adjustment of \$29,865 (water - \$15,618
18 and sewer - \$14,247).

19 Adjustment No.2 – CWS proposes to annualize operators' salaries and wages as of
20 June 30, 2004. CWS included wages for six new operators and a new project
21 manager to meet the DHEC requirements of 7-day checks of utility systems. ORS
22 adjusted for four new operators which were verified to CWS's payroll records. The

1 remaining positions were not filled and therefore not known and measurable.
2 Annualized wages totaled \$894,224, less per book wages of \$756,848 for an
3 adjustment of \$137,376. ORS capitalized \$48,562 of wages based on CWS's per
4 book capitalization ratio of 35.35% representing the time operators spent on capital
5 projects. The capitalization ratio of 35.35% is computed using per book Operating
6 Expenses Charged to Plant divided by salaries and wages for operators (\$267,522 /
7 \$756,848). ORS expensed \$88,814 of the total adjustment.

8 Adjustment No.3 – Adjustment No.9 – Consumer Price Index Adjustment - CWS
9 proposes to increase certain expenses by 5.74% to reflect inflation in accordance with
10 the Bureau of Labor and Statistics Consumer Price Index for Water and Sewerage
11 Maintenance. The expense accounts included Water and Sewerage Maintenance,
12 Maintenance and Repair Expense, Maintenance Testing Expense, Meter Reading
13 Expense, Chemicals Expense, Operating Expense Charged to Plant, and Outside
14 Services-Other Expense. ORS does not propose to adjust expenses using the CPI
15 index as these adjustments would be based upon economic forecasts rather than
16 known and measurable transactions. ORS adjusts for changes in expenses supported
17 by proper documentation of actual transactions.

18 Adjustment No.10 – Transportation Expenses – CWS proposes to increase
19 Transportation Expenses to reflect new vehicles for additional employees. CWS has
20 hired four new employees but presented no evidence of purchasing new vehicles.
21 Therefore, ORS does not propose to make this adjustment due to lack of
22 documentation supporting the purchases.

1 Adjustment No.11 – Deferred Expenses- ORS proposes to adjust Deferred Charges
2 to reflect deferred allowable expenses, which are those expenses unanticipated and
3 non-recurring. This adjustment is made in accordance with the SC Supreme Court
4 Case in Docket No. 93-738-W/S. Staff removed deferred expenses for tank
5 maintenance for water operations of (\$13,057) and included the current expenses in
6 the test year for tank maintenance of \$29,902. Additionally, ORS proposes to defer
7 hurricane and storm expenses of \$17,828 over three years ($\$17,828 / 3 \text{ years} = 5,943$
8 less \$17,828 per books) for a net amount of (\$11,885). The ORS made a total
9 adjustment to deferred expenses of \$4,960, which consisted of (\$13,057) + \$29,902 +
10 (\$11,885).

11 Adjustment No.12 - Office Salaries – ORS and CWS propose to adjust Office
12 Salaries using the employees and wage rates at June 30, 2004. Total ORS computed
13 Office Salaries was \$304,053 less the per book amount of \$290,536 for an
14 adjustment of \$13,517. The office salaries included the South Carolina office and
15 allocations from the corporate and North Carolina offices.

16 Adjustments No. 13 – 17 - Consumer Price Index Adjustment - CWS proposes to
17 increase certain expenses by 5.74% to reflect inflation in accordance with the Bureau
18 of Labor and Statistics Consumer Price Index for Water and Sewerage Maintenance.
19 The expense accounts included Office Supplies, Rent Expense, Insurance Expense,
20 Office Utilities, and Miscellaneous Expenses. ORS does not propose to adjust
21 expenses using the CPI index as these adjustments would be based upon economic

1 forecasts rather than known and measurable transactions. ORS adjusts for changes in
2 expenses supported by proper documentation of actual transactions.

3 Adjustment No. 18 – Rate Case Expenses - ORS and CWS propose to adjust for
4 rate case expenses. CWS's adjustment included estimated rate case expenses of
5 \$123,432, amortized over three years, less the per book fully amortized rate case
6 expenses of \$101,626 for an adjustment of (60,482). ORS adjusted for actual to date
7 expenses for which CWS provided support. These expenses included Legal and
8 Consulting Fees and direct time spent on the case by the corporate office staff,
9 resulting in total expenses of \$75,011. ORS examined the time between rate cases
10 for CWS and found the average time was 3 years. Total rate case expenses of
11 \$75,011 were amortized over 3 years amounting to \$25,004, less the per book fully
12 amortized amount of \$101,626, resulting in an adjustment of (\$76,622).

13 Adjustment No.19 – Annualize Pension and Other Benefits – ORS and CWS propose
14 to annualize pension and other benefits associated with the wage adjustment
15 for the Operators and Office Employees. ORS did not include pension and benefits
16 for part-time employees as CWS does not pay benefits to these employees. The total
17 ORS adjustment was \$251,971 less the per book amount of \$206,536 resulting in an
18 adjustment of \$45,435. Of this amount \$33,407 was related to the Operators' wages,
19 and ORS capitalized 35.35% or \$11,809. The remaining amount of \$33,626 was
20 expensed.

21 Adjustment No.20 – Employee Bonuses – ORS removed bonuses for CWS Office
22 Employees of \$8,225 and CWS's portion of bonuses for the Corporate Office

employees of \$14,462 for a total adjustment of (\$22,687). ORS considers bonuses the responsibility of the stockholder and notes that bonuses may be nonrecurring since they are not always awarded.

Adjustment No.21 – Out of Period Expenses – ORS proposes to remove from the test year, out of period expenses for Property Insurance (\$31,649), Sewer Rodding and Maintenance & Repairs of (\$14,415) and nonallowable DHEC fines and entertainment expenses of (\$22,850). These expenses totaled (\$68,914).

Adjustment No.22 – Depreciation Expense Adjustment – ORS and CWS propose to annualize Depreciation Expense. CWS annualized depreciation using gross plant plus estimated plant additions, reduced for Land, Vehicles, Plant Acquisition Adjustment, Advances in Aid of Construction, Removal of Wells, and excess Book Value. CWS used a depreciation rate of 1.50% (66.67 years) for plant other than vehicles, and a depreciation rate of 25.00% (4 years) for vehicles. CWS's adjustment totaled \$79,436. The ORS adjustment included gross plant plus pro forma plant verified to date of \$696,396, less Organization Expense, Land, Vehicles, Plant Acquisition Adjustment, and Advances in Aid of Construction. ORS included depreciation expense associated with the WSC Rate Base and depreciation expense for the amortization of Excess Book Value. ORS made separate adjustments for depreciation expense associated with removal of wells. ORS used a depreciation rate of 1.50% (66.67 years) for plant other than vehicles and used a depreciation rate of 16.66% (6 years) for vehicles. These rates were recommended by ORS's Water/Wastewater Department. ORS computed depreciation expense was \$572,274,

1 less the per book amount of \$589,942 for an adjustment of (\$17,668). See Audit
2 Exhibit SGS – 5 for details of the Depreciation Expense Adjustment.

3 Adjustment No.23 – Amortization of Contributions in Aid of Construction (CIAC) –

4 ORS and CWS propose to adjust the amortization of CIAC using a 1.5%
5 depreciation rate. CWS's adjustment amounted to \$15,826. ORS used its verified
6 amount for Contributions in Aid of Construction of \$15,298,753 to adjust the
7 amortization. The amount of \$15,298,753 was verified by taking the balance from
8 the last rate case of \$13,538,305 and adding \$1,760,448 from CIAC information
9 provided by CWS for January 2001 – June 30, 2004. This adjustment reduced the
10 per book amortization of CIAC. ORS computed an adjustment of \$23,109, using the
11 computed amortization of (\$229,481) less the per book amount of (\$252,590).

12 Adjustment No.24 – Retired Wells – In accordance with the last rate case order,
13 ORS and CWS removed the depreciation expense associated with wells no longer
14 used and useful in River Hills, I-20, Watergate and Westside Terrace subdivisions,
15 since CWS still has the wells on its books. ORS adjusted depreciation expense for
16 (\$7,568) in accordance with CWS's last rate case order. CWS subtracted
17 depreciation expense associated with the retired wells in its depreciation expense
18 adjustment.

19 Adjustment No.25 - Extraordinary Retirement of Wells – In accordance with the last
20 rate case order, ORS and CWS increased expenses for the extraordinary retirement of
21 the wells in River Hills, I-20, Watergate, and Westside Terrace subdivisions. The
22 wells were considered no longer used and useful. The amortization period is 10

1 years, which expires in 2010. ORS made the adjustment for \$29,924 as stated in
2 CWS's last rate case order.

3 Adjustment No.26 – Property Taxes – In accordance with the last rate case order,
4 ORS removed property taxes associated with the retired wells in River Hills, I-20,
5 Watergate, and Westside Terrace subdivisions since CWS has not removed the wells
6 from the books. The adjustment is a reduction to property taxes of (\$8,559).

7 Adjustment No.27 – Payroll Taxes – ORS and CWS propose to adjust for payroll
8 taxes associated with the wage adjustment. The payroll taxes include FICA, SUTA,
9 and FUTA taxes. ORS computed taxes of \$94,215 less the per book amount of
10 \$81,580, resulting in an adjustment of \$12,635. Of this amount, \$9,464 is related to
11 the operators' salaries and 35.35% or \$3,346 is capitalized and remaining amount of
12 \$9,289 is expensed.

13 Adjustment No.28– Other Taxes - ORS proposes to reflect the Utility/Commission
14 taxes and gross receipts taxes associated with as adjusted revenue. The factor
15 includes costs for administration for the Public Service Commission and ORS of
16 .007733226, and a revenue tax from the SC Department of Revenue of .003 for a
17 total factor of .010733226. This factor is applied to As Adjusted Revenue of
18 \$5,674,555 for a computed amount of \$60,906 less the per book amount of \$58,250
19 resulting in an adjustment of \$2,656.

20 Adjustment No.29 – Property Taxes - ORS proposes to make an adjustment to reflect
21 the actual test year expenses for property taxes by including \$264,492 paid by CWS
22 during the test year which was improperly recorded.

1 Adjustment No.30 – Income Taxes – CWS and ORS propose to adjust income taxes
2 after the accounting and pro forma adjustments. CWS uses flat rates of 5% for state
3 taxes and 34% for federal taxes. ORS used 5% for state taxes and the graduated tax
4 rates of 15%, 25%, 34% and 39% from the Internal Revenue Service's corporate
5 income tax rates. See Audit Exhibit SGS – 6.

6 Adjustment No.31 – Interest on Customer Deposits – ORS proposes to annualize
7 Interest on Customer Deposits by using ORS verified amount at June 30, 2004 of
8 \$183,354 and the PSC approved interest rate of 3.5%. ORS computed annualized
9 Interest on Customer Deposits of \$6,417, less the per book amount of \$9,728, for an
10 adjustment of (\$3,311).

11 Adjustment No.32 – Allowance for Funds Used During Construction (AFUDC) –
12 Both ORS and CWS propose to remove the income associated with capitalized
13 interest for projects under construction. CWS does not propose to include
14 Construction Work In Progress and therefore, the income associated with CWIP is
15 not included as an offset to expenses. The adjustment amounted to (\$17,756).

16 Adjustment No.33 - Remove Wells – ORS and CWS propose to remove wells no
17 longer used and useful in accordance with the last CWS rate case order. The wells
18 were in the River Hills, I-20, Watergate, and Westside Terrace subdivisions. The
19 total amount of (\$299,237) is a reduction to Plant in Service. CWS used an amount
20 of \$277,315, which was \$288,119 for the last rate case less accumulated depreciation
21 of \$10,804. CWS did not include plant costs for Westside Terrace of \$11,118 from

1 the last rate case and depreciation expense is not longer allowed since these wells are
2 being written off as an extraordinary retirement.

3 Adjustment No.34 – Excess Book Value - ORS and CWS propose to remove Excess
4 Book Value carried forth from the last rate case. The Excess Book Value balance of
5 \$1,026,646 is amortized at 1.50% per year since the last rate case for a reduction to
6 plant of (\$924,905). This amount represents excess book value above CWS's
7 investment in certain plant items, which is not allowable for ratemaking purposes.
8 CWS's adjustment was for \$941,517, computed using an Excess Book Value balance
9 of \$978,199 less accumulated depreciation of \$36,682. CWS used the incorrect
10 carry forward amount of \$978,199.

11 Adjustment No.35 - Plant Sample Items – In accordance with the last rate case order,
12 both ORS and CWS propose to remove plant sample items from rate base since CWS
13 did not make the adjustment per books. The adjustment per rate case order was a
14 reduction to plant of (\$8,597). CWS's adjustment was for \$9,108, which was
15 computed by removing the plant sample items of \$8,853 and \$255. The amount of
16 \$255 was an addition to rate base instead of a subtraction.

17 Adjustment No. 36 – Plant Additions – ORS and CWS propose to adjust for plant
18 additions. ORS verified a total of \$696,396 for plant additions and capitalized time.
19 ORS allowed verifiable plant after the test year until December 31, 2004. This plant
20 is known and measurable and providing service to present customers.

1 Adjustment No. 37 – Vehicles for New Employees – CWS proposes to add vehicles
2 totaling \$138,000 for new employees. ORS found no known and measurable data to
3 support making this adjustment.

4 Adjustment No. 38 - Pro Forma Plant – CWS proposes to adjust for other pro forma
5 plant which totaled \$1,918,185. ORS found no known and measurable data to
6 support making this adjustment.

7 Adjustment No. 39 – Capitalized Wages – ORS proposes to book to plant the portion
8 of operators' wages, taxes, and benefits associated with capital projects in accordance
9 with CWS's capitalization ratio of 35.35%. The factor was computed using per book
10 Total Wages Charged to Plant of \$267,522 divided by the Total Operating and
11 Maintenance Salaries for operators of \$756,848. ORS adjusted for operators'
12 capitalized wages of \$48,562 and capitalized taxes and benefits of \$15,155 for a total
13 adjustment of \$63,717.

14 Adjustment No. 40 - Accumulated Depreciation – CWS proposes to adjust
15 accumulated depreciation for the removal of wells, excess book value and post
16 6/30/04 plant additions. ORS proposes to adjust accumulated depreciation for the
17 annualized depreciation expense of \$17,668 as shown on Audit Exhibit SGS - 5.

18 Adjustment No. 41 – Cash Working Capital – ORS and CWS propose to adjust Cash
19 Working Capital for pro forma expenses. This adjustment reflects the working
20 capital needed prospectively based on the accounting and pro forma adjustments.
21 ORS did not include Taxes Other Than Income as a working capital item since it is
22 normally an accrual that does not require a cash outlay, and since CWS would have

1 collected from its customers funds in advance of paying certain taxes. ORS
2 adjustment amounted to (\$61,479).

3 Adjustment No. 42 – Water Service Corporation (WSC) - Rate Base - ORS proposes
4 to adjust the WSC Rate Base allocated to CWS. ORS verified the rate base to
5 WSC's books and records and removed deferred charges allocated to CWS of
6 (\$2,609). The recovery of certain deferred charges are allowed in expenses but not in
7 rate base which results in a sharing of the expenses between the customer and
8 stockholder.

9 Adjustment No. 43 – Advances in Aid of Construction – ORS proposes to remove
10 Advances in Aid of Construction of \$1,600 from Rate Base, which are owed to the
11 customer. CWS should not be allowed to earn a return on customer supplied funds.

12 Adjustment No. 44 – Contributions in Aid of Construction – ORS proposes to adjust
13 the balance for CIAC to the amount verified during the audit. ORS used the balance
14 from the last rate case of \$13,538,305, and added \$1,760,448 from CIAC information
15 provided by CWS for January 2001 – June 30, 2004 for a total balance of
16 \$15,298,753. The ORS verified amount of \$15,298,753, less the per book amount of
17 \$15,195,347, produced a total adjustment of \$103,406. The adjustment increases the
18 amount of CIAC removed from rate base.

19 Adjustment No. 45 – Customer Deposits - ORS proposes to remove Accrued Interest
20 of (\$245,763) from CWS's rate base. These funds are owed to the customer and
21 should be removed from rate base.

1 Adjustment No.46 – Interest Expense – ORS and CWS propose to adjust allowable
2 Interest Expense to reflect the As Adjusted Rate Base, capital structure of 59.23% for
3 debt, 40.77% for equity and a cost of debt of 7.28%. ORS's adjustment is (\$98,549),
4 allowable interest expense of \$636,879 less the per book amount of \$735,428. CWS
5 used its pro forma Rate Base to compute Interest Expense. See Audit Exhibit SGS –
6 9 for ORS's computed Interest Expense.

7 Adjustment No. 47 – Operating Revenues - Proposed Increase – Both ORS and CWS
8 propose to include the requested service revenues. The total requested revenue is
9 \$1,815,528, comprised of \$180,854 for water service revenue and \$1,634,674 for
10 sewer service revenue.

11 Adjustment No. 48 – Uncollectible Accounts – Proposed Increase - ORS and CWS
12 propose to adjust for uncollectible revenue associated with the proposed revenues
13 using the uncollectible factors for the test year of .7525% for water and .7756% for
14 sewer. ORS's Water/Wastewater Department verified that the factors were
15 reasonable based on their examination of the billing records.

16 Adjustment No. 49 – Taxes Other Than Income – Proposed Increase – ORS and
17 CWS propose to adjust utility/commission taxes and gross receipts taxes associated
18 with the proposed revenue. ORS used a factor of .010733226 which is comprised of
19 the Public Service Commission and Office of Regulatory Staff's factor of
20 .007733226 and the Department of Revenue's factor of .003. ORS's total adjustment
21 is \$19,486.

1 Adjustment No. 50 – Income Taxes – Proposed Increase – ORS and CWS propose
2 to adjust Income Taxes for the Proposed Increase. CWS used a 5.00% rate for state
3 taxes and a composite rate of 34% for federal taxes. ORS used a 5.00% rate for
4 state taxes and the Internal Revenue Service Corporate Income Tax brackets of
5 15%, 25%, 34% and 39% from the Internal Revenue Service's corporate income tax
6 rates. See Audit Exhibit SGS – 6.

7 **PLEASE DESCRIBE THE REMAINING AUDIT EXHIBITS.**

8 A. Audit Exhibit SGS-5 shows the Depreciation Expense Adjustment. Audit Exhibit
9 SGS-6 shows the Computation of Income Taxes. Audit Exhibit SGS-7 shows
10 Customer Growth Computation. Audit Exhibit SGS - 8 shows the Cash Working
11 Capital Allowance. Audit Exhibit SGS - 9 shows the Return on Common Equity.
12 Audit Exhibit SGS- 10 shows the Income Statement for the Test Year Ended June 30,
13 2004. Audit Exhibit SGS - 11 shows the Balance Sheet for the Test Year Ended June
14 30, 2004.

15 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

16 A. Yes, it does.

DIRECT EXHIBITS

OF

SHARON G. SCOTT

**DOCKET NO. 2004-357-W/S
APPLICATION OF
CAROLINA WATER SERVICE, INC.
FOR ADJUSTMENT OF
RATES AND CHARGES**

REPORT OF THE AUDIT DEPARTMENT
THE OFFICE OF REGULATORY STAFF

DOCKET NO. 2004-357-W/S
CAROLINA WATER SERVICE, INC.

REPORT OF THE AUDIT DEPARTMENT

THE OFFICE OF REGULATORY STAFF

DOCKET NO. 2004-357-W/S

CAROLINA WATER SERVICE, INC.

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REPORT OF THE AUDIT DEPARTMENT

THE OFFICE OF REGULATORY STAFF

DOCKET NO. 2004-357-W/S

CAROLINA WATER SERVICE, INC.

SYNOPSIS

Amount Requested - Water----- \$180,854
- Sewer ----- \$1,634,674
- Combined ----- \$1,815,528

<u>Return on Rate Base:</u>	<u>Combined</u>	<u>Water</u>	<u>Sewer</u>
Per Books - CWS-----	5.70%	12.48%	2.99%
As Adjusted-----	3.71%	11.36%	.93%
After Proposed Increase-----	11.65%	11.67%	11.64%

<u>Return on Common Equity:</u>	<u>Combined</u>	<u>Water</u>	<u>Sewer</u>
As Adjusted-----	(1.48%)	17.29%	(8.30%)
After Proposed Increase-----	18.00%	18.04%	17.98%

REPORT OF THE AUDIT DEPARTMENT

THE OFFICE OF REGULATORY STAFF

DOCKET NO. 2004-357-W/S

CAROLINA WATER SERVICE, INC.

ANALYSIS

ORS has performed a review of the Application of Carolina Water Service, Inc. (hereinafter referred to as "CWS") along with certain CWS's accounting records, relative to its application for authority to increase certain rates and charges in Docket No. 2004-357-W/S.

CWS is a water and wastewater utility operating in the state of South Carolina. CWS furnishes both water and sewer service to residential and commercial customers in the counties of Aiken, Beaufort, Charleston, Dorchester, Georgetown, Lexington, Orangeburg, Richland, Sumter, Williamsburg, and York. CWS's home office is located at 2335 Sanders Road, Northbrook, Illinois, 60062. Its regional office is located at 110 Queens Parkway, West Columbia, South Carolina 29169. CWS is a wholly-owned subsidiary of Utilities, Inc., which is also located at the same address in Northbrook, Illinois.

ORS respectfully submits the results of its review as follows:

1. CWS filed an application on December 17, 2004 for approval of rates and charges for water and sewer services provided to its residential and commercial customers.
2. This matter is set for public hearing on Wednesday, May 4, and Thursday, May 5, 2005 at 10:30 a.m.
3. CWS's application uses a test year ending June 30, 2004.

4. The following is a summary of CWS's most recent rates and charges:

<u>Date of Order</u>	<u>Effective Date</u>	<u>Docket Number</u>	<u>Amount Requested</u>	<u>Amount Granted</u>	<u>Rate of Return Rate Base</u>	<u>Operating Margin</u>
08/27/01	08/27/01	00-207-W/S	\$685,063	\$406,246	10.06%	12.01%
05/31/94	05/31/94	93-738-W/S	\$804,492	\$664,542	-	13.86%
05/11/93	05/11/93	91-641-W/S	\$863,690	\$175,405	-	7.52%
08/01/90	08/01/90	89-610-W/S	\$967,706	\$845,976	-	10.42%
06/05/89	06/05/89	88-241-W/S	\$412,167	\$ 20,460	-	10.27%
12/01/86	12/01/86	86-220-W/S	\$414,936	\$287,875	-	11.38%

ORS's exhibits related to CWS's proposed increase are as follows:

EXHIBIT SGS-1: OPERATING EXPERIENCE, RATE BASE, AND RATES OF RETURN-COMBINED

Shown in this exhibit is CWS's Operating Experience, Rate Base, and Rates of Return for the test year ended June 30, 2004. The exhibit's format is designed to reflect per book information and applicable accounting and pro forma adjustments necessary to correct or normalize the results of CWS's test year operations.

ORS verified the per book balances to the books and records of CWS. The book figures reflect that Operating Revenues for CWS totaled \$5,644,690 and Net Operating Income totaled \$890,912 plus the Allowance for Funds Used During Construction of \$17,756, for Total Income For Return of \$908,668. CWS's per book Rate Base was \$15,639,930. As shown in the application, CWS computed a per book Rate of Return on Rate Base of 5.70% using Net Operating Income of \$890,912 and a rate base of \$15,639,930. The net effect of the Accounting and Pro forma adjustments produced Operating Revenues of \$5,674,555, Net Income for Return of \$547,474, and a Total Rate Base of \$14,770,115. Using the Net Income for Return and Total Rate Base, ORS computed a Rate of Return on Rate Base of 3.71% for as adjusted operations.

CWS has requested an increase in rates which would produce additional gross annual revenues of \$1,815,528, comprised of a water increase of \$180,854 and a sewer increase of \$1,634,674. ORS adjusted for uncollectible revenue, utility/commission, gross receipts taxes and income taxes associated with the proposed increase.

After the proposed increase, Total Operating Revenues were \$7,476,043 and Net Income for Return of was \$1,720,718. Total Rate Base after the proposed increase was \$14,770,115. Using Net Income for Return and Total Rate Base after the proposed increase, ORS computed a Rate of Return on Rate Base of 11.65%.

**EXHIBIT SGS-2: OPERATING EXPERIENCE, RATE BASE AND RATES OF RETURN-
WATER**

Shown in this ORS exhibit is the Operating Experience, Rate Base, and Rate of Return for CWS's Water Operations.

**EXHIBIT SGS-3: OPERATING EXPERIENCE, RATE BASE, AND RATES OF RETURN-
SEWER**

Shown in this ORS exhibit is the Operating Experience, Rate Base, and Rate of Return for CWS's Sewer Operations.

**EXHIBIT SGS-4: EXPLANATION OF ACCOUNTING AND PRO FORMA ADJUSTMENTS-
WATER, SEWER, AND COMBINED**

Shown in this exhibit are the details of accounting and pro forma adjustments made to correct or normalize CWS's water and sewer operations and to reflect the proposed increase. For comparative purposes, ORS and CWS's adjustments are both presented in this exhibit.

EXHIBIT SGS-5: DEPRECIATION EXPENSE ADJUSTMENT

Shown in this exhibit are ORS's computations of the adjustments to Depreciation Expense and the amortization of Contributions in Aid of Construction (CIAC). The Depreciation rates of

1.50% (66.67 years) used for plant in service and 16.667% (6 years) used for vehicles, were recommended by ORS's Water/Wastewater Department.

EXHIBIT SGS-6: COMPUTATION OF INCOME TAXES

Shown in this exhibit is ORS's computation of State and Federal Income Taxes based on taxable income after accounting and pro forma adjustments and after the effect of the requested increase. ORS used the state tax rate of 5% and federal tax rates of 15%, 25%, 34%, and 39%. CWS used the state tax rate of 5% and a composite federal tax rate of 34%.

EXHIBIT SGS-7: CUSTOMER GROWTH COMPUTATION

Shown in this exhibit is the computation of CWS's customer growth. ORS used the number of customers at 12/31/2003 and 12/31/2004 to compute the growth factor. Since ORS proposes to include plant additions as of 12/31/2004, the customer growth includes that period. ORS computed a growth factor of 1.82% for water operations and a growth factor of 1.36% for sewer operations. Combined customer growth was computed by adding water customer growth and sewer customer growth.

EXHIBIT SGS-8: CASH WORKING CAPITAL ALLOWANCE

Shown in ORS's exhibit is the calculation of cash working capital based on as adjusted operations at June 30, 2004. ORS uses a forty-five day cash working capital allowance since CWS bills in arrears.

EXHIBIT SGS-9: RETURN ON COMMON EQUITY – WATER, SEWER, AND COMBINED

CWS's return on common equity is computed both before and after the requested increase. The rate base, as shown on Audit Exhibit SGS-1, is allocated among the various classes of debt and equity according to the respective ratios as computed using CWS parent company's capital structure as of December 31, 2003.

ORS computed the amount of total income for return necessary to cover an embedded cost

rate of 7.28% on long-term debt. The remainder of total income for return for combined operations produces a return of (1.48%) to common equity before the requested increase. The overall cost of capital after accounting and pro forma adjustments is 3.71%. Such overall cost equals the rate of return on rate base shown on Audit Exhibit SGS-1.

After the requested increase of \$1,815,528, income available to common equity increases to \$1,083,839 and return on common equity increases to 18.00%. Overall cost of capital as shown in this exhibit equals 11.65%. Such overall cost of capital equals the rate of return on rate base on Audit Exhibit SGS-1.

Included in this exhibit is the Return on Common Equity as allocated to CWS's water and sewer operations.

EXHIBIT SGS-10: INCOME STATEMENT

CWS's Income Statement for the test year ending June 30, 2004 is reflected in this exhibit.

ORS verified the income statement to the books and records of CWS.

EXHIBIT SGS-11: BALANCE SHEET

Shown in this exhibit is the Balance Sheet of CWS as of June 30, 2004. ORS verified the balances contained in this statement to the books and records of CWS.

Audit Exhibit SGS-1

Carolina Water Service, Inc.
Operating Experience, Rate Base and Rates of Return
For the Test Year Ended June 30, 2004
Combined

Description	Per Company Books \$	Accounting & Pro Forma Adjustments \$	As Adjusted \$	Effect of Proposed Increase \$	After Proposed Increase \$
<u>Operating Revenues:</u>					
Service Revenue - Water	1,820,651	15,618 (A)	1,836,269	180,854 (R)	2,017,123
Service Revenue - Sewer	3,760,081	14,247 (A)	3,774,328	1,634,674 (R)	5,409,002
Miscellaneous Revenues	106,827	0	106,827	0	106,827
Uncollectible Accounts	(42,869)	0	(42,869)	(14,040) (S)	(56,909)
<u>Total Operating Revenues</u>	<u>5,644,690</u>	<u>29,865</u>	<u>5,674,555</u>	<u>1,801,488</u>	<u>7,476,043</u>
<u>Operating Expenses:</u>					
Operating & Maintenance Expenses	3,046,190	93,774 (B)	3,139,964	0	3,139,964
General & Administrative Expenses	1,032,134	(121,080) (C)	911,054	0	911,054
Depreciation & Amortization Expenses	337,352	(2,127) (D)	335,225	0	335,225
Extraordinary Retirement	0	29,924 (E)	29,924	0	29,924
Taxes Other Than Income	464,537	267,878 (F)	732,415	19,486 (T)	751,901
Income Taxes	(117,583)	117,583 (G)	0	624,554 (U)	624,554
Amortization of Investment Tax Credit	(8,852)	0	(8,852)	0	(8,852)
Interest on Customer Deposits	0	(3,311) (H)	(3,311)	0	(3,311)
<u>Total Operating Expenses</u>	<u>4,753,778</u>	<u>382,641</u>	<u>5,136,419</u>	<u>644,040</u>	<u>5,780,459</u>
<u>Total Operating Income</u>	<u>890,912</u>	<u>(352,776)</u>	<u>538,136</u>	<u>1,157,448</u>	<u>1,695,584</u>
AFUDC	17,756	(17,756) (I)	0	0	0
Customer Growth - Audit Exhibit SGS - 7	0	9,338	9,338	15,796	25,134
<u>Net Income for Return</u>	<u>908,668</u>	<u>(361,194)</u>	<u>547,474</u>	<u>1,173,244</u>	<u>1,720,718</u>
<u>Original Cost Rate Base:</u>					
Gross Plant in Service	37,107,047	(472,626) (J)	36,634,421	0	36,634,421
Accumulated Depreciation	(4,781,897)	17,668 (K)	(4,764,229)	0	(4,764,229)
Net Plant in Service	32,325,150	(454,958)	31,870,192	0	31,870,192
Cash Working Capital	567,857	(61,479) (L)	506,378	0	506,378
Water Service Corporation - Rate Base	130,433	(2,609) (M)	127,824	0	127,824
Advances in Aid of Construction	0	(1,600) (N)	(1,600)	0	(1,600)
Contributions in Aid of Construction	(15,195,347)	(103,406) (O)	(15,298,753)	0	(15,298,753)
Plant Acquisition Adjustment	(482,719)	0	(482,719)	0	(482,719)
Accumulated Deferred Income Taxes	(1,522,090)	0	(1,522,090)	0	(1,522,090)
Customer Deposits	(183,354)	(245,763) (P)	(429,117)	0	(429,117)
<u>Total Rate Base</u>	<u>15,639,930</u>	<u>(869,815)</u>	<u>14,770,115</u>	<u>0</u>	<u>14,770,115</u>
<u>Return on Rate Base (Note)</u>	<u>5.70%</u>		<u>3.71%</u>		<u>11.65%</u>
<u>Interest Expense</u>	<u>735,428</u>	<u>(98,549) (Q)</u>	<u>636,879</u>		<u>636,879</u>

Note - Per Book Return on Rate Base computed per Company based on per book Total Operating Income and Total Rate Base

Carolina Water Service, Inc.
Operating Experience, Rate Base and Rates of Return
For the Test Year Ended June 30, 2004
Water

Description	Per Company Books \$	Accounting & Pro Forma Adjustments \$		As Adjusted \$	Proposed Increase \$	After Proposed Increase \$
Operating Revenues:						
Service Revenue - Water	1,820,651	15,618 (A)		1,836,269	180,854 (R)	2,017,123
Miscellaneous Revenues	31,199	0		31,199	0	31,199
Uncollectible Accounts	(13,705)	0		(13,705)	(1,361) (S)	(15,066)
Total Operating Revenues	1,838,145	15,618		1,853,763	179,493	2,033,256
Operating Expenses:						
Operating & Maintenance Expenses	658,476	34,659 (B)		693,135	0	693,135
General & Administrative Expenses	381,477	(44,751) (C)		336,726	0	336,726
Depreciation & Amortization Expenses	125,688	(16,197) (D)		109,491	0	109,491
Extraordinary Retirement	0	29,924 (E)		29,924	0	29,924
Taxes Other Than Income	155,787	93,612 (F)		249,399	1,941 (T)	251,340
Income Taxes	(37,591)	37,591 (G)		0	165,696 (U)	165,696
Amortization of Investment Tax Credit	(2,631)	0		(2,631)	0	(2,631)
Interest on Customer Deposits	0	(1,224) (H)		(1,224)	0	(1,224)
Total Operating Expenses	1,281,206	133,614		1,414,820	167,637	1,582,457
Total Operating Income	556,939	(117,996)		438,943	11,856	450,799
AFUDC	5,277	(5,277) (I)		0	0	0
Customer Growth - Audit Exhibit SGS - 7	0	7,989		7,989	216	8,205
Net Income for Return	562,216	(115,284)		446,932	12,072	459,004
Original Cost Rate Base:						
Gross Plant in Service	11,532,256	(398,287) (J)		11,133,969	0	11,133,969
Accumulated Depreciation	(1,925,249)	13,765 (K)		(1,911,484)	0	(1,911,484)
Net Plant in Service	9,607,007	(384,522)		9,222,485	0	9,222,485
Cash Working Capital	149,467	(20,734) (L)		128,733	0	128,733
Water Service Corporation - Rate Base	48,206	(964) (M)		47,242	0	47,242
Advances in Aid of Construction	0	(800) (N)		(800)	0	(800)
Contributions in Aid of Construction	(4,470,536)	(30,422) (O)		(4,500,958)	0	(4,500,958)
Plant Acquisition Adjustment	(217,337)	0		(217,337)	0	(217,337)
Accumulated Deferred Income Taxes	(587,068)	0		(587,068)	0	(587,068)
Customer Deposits	(67,768)	(90,834) (P)		(158,602)	0	(158,602)
Total Rate Base (Note)	4,461,971	(528,276)		3,933,695	0	3,933,695
Return on Rate Base	12.48%			11.36%		11.67%
Interest Expense	219,188	(49,569) (Q)		169,619		169,619

Note - Per Book Return on Rate Base computed per Company based on per book Total Operating Income and Total Rate Base

Carolina Water Service, Inc.
Operating Experience, Rate Base and Rates of Return
For the Test Year Ended June 30, 2004
Sewer

Description	Per Company Books \$	Accounting & Pro Forma Adjustments \$		As Adjusted \$	Proposed Increase \$	After Proposed Increase \$
Operating Revenues:						
Service Revenue - Sewer	3,760,081	14,247 (A)		3,774,328	1,634,674 (R)	5,409,002
Miscellaneous Revenues	75,628	0		75,628	0	75,628
Uncollectible Accounts	(29,164)	0		(29,164)	(12,679) (S)	(41,843)
Total Operating Revenues	3,806,545	14,247		3,820,792	1,621,995	5,442,787
Operating Expenses:						
Operating & Maintenance Expenses	2,387,714	59,115 (B)		2,446,829	0	2,446,829
General & Administrative Expenses	650,657	(76,329) (C)		574,328	0	574,328
Depreciation & Amortization Expenses	211,664	14,070 (D)		225,734	0	225,734
Extraordinary Retirement	0	0 (E)		0	0	0
Taxes Other Than Income	308,750	174,266 (F)		483,016	17,545 (T)	500,561
Income Taxes	(79,992)	79,992 (G)		0	458,858 (U)	458,858
Amortization of Investment Tax Credit	(6,221)	0		(6,221)	0	(6,221)
Interest on Customer Deposits	0	(2,087) (H)		(2,087)	0	(2,087)
Total Operating Expenses	3,472,572	249,027		3,721,599	476,403	4,198,002
Total Operating Income	333,973	(234,780)		99,193	1,145,592	1,244,785
AFUDC	12,479	(12,479) (I)		0	0	0
Customer Growth - Audit Exhibit SGS - 7	0	1,349		1,349	15,580	16,929
Net Income for Return	346,452	(245,910)		100,542	1,161,172	1,261,714
Original Cost Rate Base:						
Gross Plant in Service	25,574,791	(74,339) (J)		25,500,452	0	25,500,452
Accumulated Depreciation	(2,856,648)	3,903 (K)		(2,852,745)	0	(2,852,745)
Net Plant in Service	22,718,143	(70,436)		22,647,707	0	22,647,707
Cash Working Capital	418,390	(40,745) (L)		377,645	0	377,645
Water Service Corporation - Rate Base	82,227	(1,645) (M)		80,582	0	80,582
Advances in Aid of Construction	0	(800) (N)		(800)	0	(800)
Contributions in Aid of Construction	(10,724,811)	(72,984) (O)		(10,797,795)	0	(10,797,795)
Plant Acquisition Adjustment	(265,382)	0		(265,382)	0	(265,382)
Accumulated Deferred Income Taxes	(935,022)	0		(935,022)	0	(935,022)
Customer Deposits	(115,586)	(154,929) (P)		(270,515)	0	(270,515)
Total Rate Base	11,177,959	(341,539)		10,836,420	0	10,836,420
Return on Rate Base (Note)	2.99%			0.93%		11.64%
Interest Expense	516,240	(48,980) (Q)		467,260		467,260

Note - Per Book Return on Rate Base computed per Company based on per book Total Operating Income and Total Rate Base

Carolina Water Service, Inc.
Explanation of Accounting and Pro Forma Adjustments
For the Test Year Ended June 30, 2004

<u>Description</u>	<u>Water</u> \$	<u>Sewer</u> \$	<u>Combined</u> \$
(A) Operating Revenues			
As Adjusted			
1 ORS proposes to adjust operating revenues to reflect current customers at current rates.			
Per ORS	15,618	14,247	29,865
Per CWS	0	0	0
(B) Operating and Maintenance			
2 CWS proposes to annualize operators' Salaries and Wages expense as of June 30, 2004. ORS proposes to annualize wages using employees at June 30, 2004 and for actual employees hired after the test year. In conformance with CWS's capitalization policy, ORS capitalized 35 35% of the wage adjustment.			
Per ORS	32,826	55,988	88,814
Per CWS	87,492	149,269	236,761
3 CWS proposes to increase Purchased Power expense by 5.74% to reflect inflation in accordance with the Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	5,273	18,992	24,265
4 CWS proposes to increase Maintenance and Repair expense by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	7,318	86,800	94,118
5 CWS proposes to increase Maintenance Testing expense by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	304	2,149	2,453

Carolina Water Service, Inc.
Explanation of Accounting and Pro Forma Adjustments
For the Test Year Ended June 30, 2004

<u>Description</u>	<u>Water</u> \$	<u>Sewer</u> \$	<u>Combined</u> \$
6 CWS proposes to increase Meter Reading expense by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	2,389	0	2,389
7 CWS proposes to increase Chemicals expense by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	4,571	7,797	12,368
8 CWS proposes to increase Operating Expense Charged to Plant by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	(30,926)	(52,762)	(83,688)
9 CWS proposes to increase Outside Services - Other Expense by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	2,782	4,745	7,527
10 CWS proposes to increase Transportation expenses to reflect the purchase of new vehicles for additional employees. ORS made no adjustment since there was no known and measurable information available.			
Per ORS	0	0	0
Per CWS	4,884	11,550	16,434
11 In compliance with the prior rate case order, ORS proposes to remove CWS deferred expenses that are recurring and anticipated such as tank maintenance. ORS proposes to include the current expense in the test year and amortize hurricane and storm expenses.			
Per ORS	1,833	3,127	4,960
Per CWS	0	0	0
<u>Total Operating and Maintenance</u>	<u>34,659</u>	<u>59,115</u>	<u>93,774</u>

Carolina Water Service, Inc.
Explanation of Accounting and Pro Forma Adjustments
For the Test Year Ended June 30, 2004

Description	Water \$	Sewer \$	Combined \$
(C) General and Administrative			
12 ORS and CWS propose to annualize Office Salaries, Wages, and benefits as of 6/30/2004. ORS proposes to annualize wages using only current employees at June 30, 2004 and current wages.			
Per ORS	4,996	8,521	13,517
Per CWS	13,108	22,371	35,479
13 CWS proposes to increase Office Supplies and Other Office expense by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	3,530	6,021	9,551
14 CWS proposes to increase Rent expense by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	73	125	198
15 CWS proposes to increase Insurance expense by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	3,168	5,403	8,571
16 CWS proposes to increase Office Utilities expense by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	1,398	2,384	3,782

Carolina Water Service, Inc.
Explanation of Accounting and Pro Forma Adjustments
For the Test Year Ended June 30, 2004

Description	Water \$	Sewer \$	Combined \$
17 CWS proposes to increase Miscellaneous expense by 5.74% to reflect inflation in accordance with Bureau of Labor Statistic's Consumer Price Index for Water and Sewerage Maintenance. ORS does not propose to use this method to adjust expenses as these adjustments would be based upon economic forecasts rather than known and measurable transactions.			
Per ORS	0	0	0
Per CWS	1,026	1,751	2,777
18 ORS and CWS propose to amortize current rate case expenses over a three year period. ORS used known and measurable rate case expenses to date and CWS used estimated expenses. This adjustment also eliminates fully amortized per book rate case expenses of \$101,626.			
Per ORS	(28,320)	(48,302)	(76,622)
Per CWS	(22,354)	(38,128)	(60,482)
19 ORS and CWS proposes to annualize Pension and Other Benefits expense as of June 30, 2004. In conformance with CWS policy, ORS proposes to capitalize 35.35% of pension and benefits for operators only.			
Per ORS	12,428	21,198	33,626
Per CWS	25,446	43,413	68,859
20 ORS propose to remove employee bonuses from operating expenses. ORS considers bonuses the responsibility of the stockholder.			
Per ORS	(8,385)	(14,302)	(22,687)
Per CWS	0	0	0
21 ORS proposes to remove out of period expenses for property insurance, sewer rodding, and maintenance repairs. ORS also proposes to remove DHEC fines and CWS entertainment expenses.			
Per ORS	(25,470)	(43,444)	(68,914)
Per CWS	0	0	0
Total General and Administrative	(44,751)	(76,329)	(121,080)
(D) Depreciation and Amortization Expense			
22 CWS proposes to annualize Depreciation expense as of June 30, 2004, which included estimated plant additions. ORS annualizes depreciation expense as of June 30, 2004 for known and measurable net plant in service.			
Per ORS	(13,765)	(3,903)	(17,668)
Per CWS	3,864	75,572	79,436

Carolina Water Service, Inc.
Explanation of Accounting and Pro Forma Adjustments
For the Test Year Ended June 30, 2004

<u>Description</u>	<u>Water</u> \$	<u>Sewer</u> \$	<u>Combined</u> \$
23 ORS and CWS propose to annualize Amortization of CIAC expense as of June 30, 2004. The purpose of this adjustment is to properly calculate amortization expense associated with CIAC.			
Per ORS	5,136	17,973	23,109
Per CWS	8,003	7,823	15,826
24 ORS proposes to remove depreciation expense associated with the retired wells as approved in the last rate case. CWS included this amount in its proposed depreciation expense adjustment.			
Per ORS	(7,568)	0	(7,568)
Per CWS	0	0	0
<u>Total Depreciation and Amortization Expense</u>	<u>(16,197)</u>	<u>14,070</u>	<u>(2,127)</u>
<u>(E) Extraordinary Retirement of Wells</u>			
25 CWS and ORS adjust for the extraordinary retirement of wells as approved in the last rate case.			
Per ORS	29,924	0	29,924
Per CWS	29,294	0	29,294
<u>(F) Taxes Other Than Income</u>			
26 ORS proposes to remove property taxes associated with the retired wells as approved in the last rate case.			
Per ORS	(8,559)	0	(8,559)
Per CWS	0	0	0
27 CWS proposes to annualize payroll taxes as of June 30, 2004. ORS adjusted payroll taxes for the annualized payroll adjustment and capitalized a portion of the expenses for operators' wages in accordance with CWS's capitalization rate of 35.35%.			
Per ORS	3,433	5,856	9,289
Per CWS	7,897	13,474	21,371
28 ORS proposes to adjust utility/commission taxes and gross receipts taxes for the as adjusted revenue.			
Per ORS	982	1,674	2,656
Per CWS	0	0	0
29 ORS proposes to adjust property taxes to reflect actual test year expense.			
Per ORS	97,756	166,736	264,492
Per CWS	0	0	0
<u>Total Taxes Other Than Income</u>	<u>93,612</u>	<u>174,266</u>	<u>267,878</u>

Carolina Water Service, Inc.
Explanation of Accounting and Pro Forma Adjustments
For the Test Year Ended June 30, 2004

Description	Water \$	Sewer \$	Combined \$
(G) Income Taxes - As Adjusted			
30 CWS records income taxes using current tax rates on calculated taxable income. ORS proposes to compute income taxes after accounting and pro forma adjustments. See Audit Exhibit SGS - 6			
Per ORS	37,591	79,992	117,583
Per CWS	110,855	(168,135)	(57,280)
(H) Interest on Customer Deposits			
31 ORS proposes to annualize interest on customer deposits using the test year ending balance and the most recent approved interest rate of 3.50%.			
Per ORS	(1,224)	(2,087)	(3,311)
Per CWS	0	0	0
(I) Allowance for Funds Used During Construction (AFUDC)			
32 CWS and ORS propose to eliminate all AFUDC for rate making purposes. CWS and ORS did not include Construction Work in Progress in rate base and therefore AFUDC is eliminated as an addition to net income			
Per ORS	(5,277)	(12,479)	(17,756)
Per CWS	(5,277)	(12,479)	(17,756)
(J) Gross Plant In Service			
33 CWS proposes to remove wells no longer used and useful per the last rate case. CWS did not make the adjustments on their books. ORS also proposes to remove the wells per the last rate case for wells at I-20, Watergate, River Hills and Westside Terrace subdivisions.			
Per ORS	(299,237)	0	(299,237)
Per CWS	(277,315)	0	(277,315)
34 ORS and CWS propose to remove excess book value carried forth from the last rate case.			
Per ORS	(274,974)	(649,931)	(924,905)
Per CWS	(279,819)	(661,698)	(941,517)
35 CWS and ORS propose to remove a plant sample item approved in the last rate case.			
Per ORS	(2,555)	(6,042)	(8,597)
Per CWS	(2,707)	(6,401)	(9,108)
36 ORS and CWS propose to adjust Plant in Service for capitalized plant and time after 6/30/2004.			
Per ORS	154,929	541,467	696,396
Per CWS	168,147	360,433	528,580

Carolina Water Service, Inc.
Explanation of Accounting and Pro Forma Adjustments
For the Test Year Ended June 30, 2004

Description	Water \$	Sewer \$	Combined \$
37 CWS proposes to add vehicles for new employees. ORS did not make this adjustment since no known and measurable data was available.			
Per ORS	0	0	0
Per CWS	41,014	96,986	138,000
38 CWS proposes to adjust for other pro forma plant. ORS adjusted for only pro forma plant capitalized after the test year and placed in service as of 12/31/2004.			
Per ORS	0	0	0
Per CWS	291,348	1,626,837	1,918,185
39 ORS proposes to capitalize wages, taxes, and benefits as a result of the payroll adjustment based on CWS capitalization policy of 35.35%.			
Per ORS	23,550	40,167	63,717
Per CWS	0	0	0
Total Gross Plant In Service	(398,287)	(74,339)	(472,626)
(K) Accumulated Depreciation			
40 CWS proposes to adjust accumulated depreciation for the removal of wells, excess book value and post 6/30/04 plant additions. ORS proposes to adjust accumulated depreciation for the annualized depreciation expense.			
Per ORS	13,765	3,903	17,668
Per CWS	18,451	17,078	35,529
(L) Cash Working Capital			
41 CWS and ORS propose to adjust Cash Working Capital based on pro forma expenses. ORS did not include Taxes Other Than Income in its computation.			
Per ORS	(20,734)	(40,745)	(61,479)
Per CWS	14,673	35,670	50,343
(M) Water Service Corporation - Rate Base			
42 ORS proposes to remove current deferred charges from the rate base. Certain deferred charges are only allowed in expenses for determination of cost of service. CWS's adjustment includes the adjustment to deferred expenses from the last rate case.			
Per ORS	(964)	(1,645)	(2,609)
Per CWS	(2,513)	(5,944)	(8,457)

Carolina Water Service, Inc.
Explanation of Accounting and Pro Forma Adjustments
For the Test Year Ended June 30, 2004

<u>Description</u>	<u>Water</u> \$	<u>Sewer</u> \$	<u>Combined</u> \$
<u>(N) Advances in Aid of Construction</u>			
43 ORS proposes to remove Advances in Aid of Construction owed to the customer.			
Per ORS	(800)	(800)	(1,600)
Per CWS	0	0	0
<u>(O) Contributions in Aid of Construction</u>			
44 ORS proposes to adjust CIAC to reflect the balance verified as of June 30, 2004.			
Per ORS	(30,422)	(72,984)	(103,406)
Per CWS	0	0	0
<u>(P) Customer Deposits</u>			
45 ORS proposes to remove Accrued Interest owed to customers for their deposits			
Per ORS	(90,834)	(154,929)	(245,763)
Per CWS	0	0	0
<u>(Q) Interest Expense</u>			
46 ORS and CWS propose to adjust Interest on debt using a 59.23% / 40.77% debt / equity ratio and a 7.28% cost of debt. ORS proposes to compute allowable interest expense as adjusted and after the proposed increase rate base. See Audit Exhibit SGS -9.			
Per ORS	(49,569)	(48,980)	(98,549)
Per CWS	(28,134)	28,529	395
<u>(R) Operating Revenues - Proposed Increase</u>			
47 ORS and CWS propose an increase in operating revenues.			
Per ORS	180,854	1,634,674	1,815,528
Per CWS	180,854	1,634,674	1,815,528
<u>(S) Uncollectible Accounts - Proposed Increase</u>			
48 ORS and CWS propose to adjust Uncollectible Accounts expense for the proposed revenue.			
Per ORS	(1,361)	(12,679)	(14,040)
Per CWS	(1,361)	(12,679)	(14,040)

Carolina Water Service, Inc.
Explanation of Accounting and Pro Forma Adjustments
For the Test Year Ended June 30, 2004

<u>Description</u>	<u>Water</u> \$	<u>Sewer</u> \$	<u>Combined</u> \$
<u>(T) Taxes Other Than Income - Proposed Increased</u>			
49 ORS and CWS propose to adjust utility/commission tax and gross receipts taxes for the proposed revenue.			
Per ORS	1,941	17,545	19,486
Per CWS	3,255	29,424	32,679
<u>(U) Income Taxes - Proposed Increase</u>			
50 CWS records income taxes using current tax rates on calculated taxable income. ORS proposes to compute income taxes after the proposed increase.			
Per ORS	165,696	458,858	624,554
Per CWS	65,736	594,029	659,765

Carolina Water Service, Inc.
Depreciation Expense Adjustment
Test Year Ended June 30, 2004

	<u>Combined</u>	<u>Water</u>	<u>Sewer</u>
	\$	\$	\$
<u>Gross Plant</u>	37,107,047	12,174,447	24,932,600
ADD:			
Pro Forma Projects (Includes Capitalized Time)	696,396	154,929	541,467
LESS:			
Organization Expense	111,594	82,784	28,810
Land	291,237	180,189	111,048
Vehicles	328,076	121,257	206,819
Plant Acquisition Adjustment (PAA)	482,719	217,337	265,382
Advance in Aid (AIA)	1,600	800	800
Net Plant	36,588,217	11,727,009	24,861,208
Plant Depreciation @ 1.5% (66.67 years)	548,823	175,905	372,918
Vehicles	328,076	121,257	206,819
Less: Fully Depreciated Vehicles	(44,086)	(16,294)	(27,792)
	283,990	104,963	179,027
Vehicle Depreciation @ 16.667% (6 years)	47,332	17,494	29,838
WSC Rate Base Depreciation Expense	5,188	1,917	3,271
Annualization of Excess Book Value	(29,069)	(10,744)	(18,325)
Total Depreciation	572,274	184,572	387,702
Less: Per Books Depreciation	589,942	198,337	391,605
ORS Adjustment	(17,668)	(13,765)	(3,903)
Company's Adjustment	79,436	3,864	75,572
Contributions in Aid of Construction			
CIAC @ 6-30-2004	(15,298,753)	(4,500,893)	(10,797,860)
Amortization %	1.50%	1.50%	1.50%
Amortization Amount	(229,481)	(67,513)	(161,968)
Per Book Amount	(252,590)	(72,649)	(179,941)
ORS Adjustment	23,109	5,136	17,973
Company's Adjustment	15,286	8,003	7,283

Audit Exhibit SGS-6

Carolina Water Service, Inc. Computation of Income Taxes For the Test Year Ended June 30, 2004

	As Adjusted		
	Combined Operations	Water Operations	Sewer Operations
Operating Revenue As Adjusted	5,674,555	1,853,763	3,820,792
Operating Expenses As Adjusted	5,148,582	1,418,675	3,729,907
Net Operating Income Before Taxes	525,973	435,088	90,885
Less: Annualized Interest Expense	636,879	169,619	467,260
Taxable Income - State	(110,906)	265,469	(376,375)
State Income Taxes @ 5%	0	0	0
Taxable Income - Federal	(110,906)	265,469	(376,375)
Total State and Federal Income Taxes	0	0	0
Less: Income Taxes Per Book	(117,583)	(37,591)	(79,992)
Adjustment	117,583	37,591	79,992
	After Proposed Increase		
	Combined Operations	Water Operations	Sewer Operations
Operating Revenue After Proposed Increase	7,476,043	2,033,256	5,442,787
Operating Expenses After Proposed Increase	5,164,757	1,419,392	3,745,365
Net Operating Income Before Taxes	2,311,286	613,864	1,697,422
Less: Annualized Interest Expense	636,879	169,619	467,260
Taxable Income - State	1,674,407	444,245	1,230,162
State Income Taxes @ 5%	83,720	22,212	61,508
Taxable Income - Federal	1,590,687	422,033	1,168,654
Federal Income Taxes - 1st 50,000 @ 15%	7,500	1,990	5,510
Next \$25,000 @25%	6,250	1,658	4,592
Next \$25,000 @34%	8,500	2,255	6,245
\$100,000 - \$335,000 @ 39%	91,650	24,315	67,335
Over \$335,000 - \$10,000,000 @ 34%	426,934	113,266	313,668
Total State and Federal Income Taxes	624,554	165,696	458,858
Less: Income Taxes As Adjusted	0	0	0
Adjustment	624,554	165,696	458,858

Federal Income Taxes allocated between water and sewer based on percentage of Federal Taxable Income.

**Carolina Water Service, Inc.
Customer Growth Computation
Test Year Ended June 30, 2004**

	(1)	(2)	(3)
	As	Effect of	After
<u>Description</u>	<u>Adjusted</u>	<u>Proposed</u>	<u>Increase</u>
	\$	\$	\$
Water Customer Growth	7,989	216	8,205
Sewer Customer Growth	1,349	15,580	16,929
Combined Customer Growth	9,338	15,796	25,134

Number of Customers:

Beginning	15,512	Formula:			
Ending	15,996	Ending - Average	=	241	= 1.53%
Average	15,755	Average		15,755	

Water Operations:

Net Operating Income	438,943	11,856	450,799
Growth Factor	1.82%	1.82%	1.82%
Customer Growth	7,989	216	8,205

Number of Customers:

Beginning	5,733	Formula:			
Ending	5,946	Ending - Average	=	106	= 1.82%
Average	5,840	Average		5,840	

Sewer Operations:

Net Operating Income	99,193	1,145,592	1,244,785
Growth Factor	1.36%	1.36%	1.36%
Customer Growth	1,349	15,580	16,929

Number of Customers:

Beginning	9,779	Formula:			
Ending	10,050	Ending - Average	=	135	= 1.36%
Average	9,915	Average		9,915	

Note: Combined Customer Growth equals Water plus Sewer Customer Growth

Beginning Customer Growth @ 12-31-2003

Ending Customer Growth @ 12-31-2004

Audit Exhibit SGS-8

Carolina Water Service, Inc. Cash Working Capital Allowance For the Test Year Ended June 30, 2004

	<u>Combined Operations</u>	<u>Water Operations</u>	<u>Sewer Operations</u>
Operating and Maintenance - As Adjusted	3,139,964	693,135	2,446,829
General and Administrative - As Adjusted	<u>911,054</u>	<u>336,726</u>	<u>574,328</u>
Total Expenses for Computation	4,051,018	1,029,861	3,021,157
Allowable Rate	<u>12.50%</u>	<u>12.50%</u>	<u>12.50%</u>
Computed Cash Working Capital - As Adjusted	506,378	128,733	377,645
Cash Working Capital - Per Books	<u>567,857</u>	<u>149,467</u>	<u>418,390</u>
Cash Working Capital Adjustment - ORS	<u>(61,479)</u>	<u>(20,734)</u>	<u>(40,745)</u>
Cash Working Capital Adjustment - CWS	<u>50,343</u>	<u>14,673</u>	<u>35,670</u>

Carolina Water Service, Inc.
Return On Common Equity
Capital Structure at December 31, 2003

Description	Capital Structure	Water			After Proposed Increase		
		Ratio	Rate	Income For Return	Rate	Income For Return	Income For Return
		%	\$	Cost/Return	Base	Cost/Return	\$
Long-Term Debt	112,819,616	59.23%	2,329,928	7.28%	2,329,928	7.28%	169,619
Common Equity	77,650,144	40.77%	1,603,767	17.29%	1,603,767	18.04%	289,385
Totals	190,469,760	100.00%	3,933,695	11.36%	3,933,695	11.67%	459,004

Description	Capital Structure	Sewer			After Proposed Increase		
		Ratio	Rate	Income For Return	Rate	Income For Return	Income For Return
		%	\$	Cost/Return	Base	Cost/Return	\$
Long-Term Debt	112,819,616	59.23%	6,418,412	7.28%	6,418,412	7.28%	467,260
Common Equity	77,650,144	40.77%	4,418,008	-8.30%	4,418,008	17.98%	794,454
Totals	190,469,760	100.00%	10,836,420	0.93%	10,836,420	11.64%	1,261,714

Description	Capital Structure	Combined			After Proposed Increase		
		Ratio	Rate	Income For Return	Rate	Income For Return	Income For Return
		%	\$	Cost/Return	Base	Cost/Return	\$
Long-Term Debt	112,819,616	59.23%	8,748,339	7.28%	8,748,339	7.28%	636,879
Common Equity	77,650,144	40.77%	6,021,776	-1.48%	6,021,776	18.00%	1,083,839
Totals	190,469,760	100.00%	14,770,115	3.71%	14,770,115	11.65%	1,720,718

Audit Exhibit SGS-9

Used Capital Structure of Parent Company @ 12-31-2003

Audit Exhibit SGS-10

Carolina Water Service, Inc. Income Statement Test Year Ended June 30, 2004

	Combined	Water	Sewer
	\$	\$	\$
<u>Operating Revenues</u>			
Service Revenues - Water	1,820,651	1,820,651	0
Service Revenues - Sewer	3,760,081	0	3,760,081
Miscellaneous Revenues	106,827	31,199	75,628
Uncollectible Accounts	(42,869)	(13,705)	(29,164)
<u>Total Operating Revenues</u>	<u>5,644,690</u>	<u>1,838,145</u>	<u>3,806,545</u>
<u>Maintenance Expenses</u>			
Salaries and Wages	756,848	279,731	477,117
Purchased Power	422,749	91,873	330,876
Purchased Sewer & Water	(465)	59,618	(60,083)
Maintenance and Repair	1,639,682	127,483	1,512,199
Maintenance Testing	42,738	5,293	37,445
Meter Reading	41,617	41,617	0
Chemicals	215,478	79,641	135,837
Transportation	63,939	23,632	40,307
Operating Exp. Charged to Plant	(267,522)	(98,876)	(168,646)
Outside Services - Other	131,126	48,464	82,662
<u>Total</u>	<u>3,046,190</u>	<u>658,476</u>	<u>2,387,714</u>
<u>General Expenses</u>			
Salaries and Wages	290,536	107,382	183,154
Office Supplies & Other Office Exp.	166,391	61,498	104,893
Regulatory Commission Exp.	101,626	37,561	64,065
Pension & Other Benefits	206,536	76,336	130,200
Rent	3,455	1,277	2,178
Insurance	149,329	55,192	94,137
Office Utilities	65,884	24,351	41,533
Miscellaneous	48,377	17,880	30,497
<u>Total</u>	<u>1,032,134</u>	<u>381,477</u>	<u>650,657</u>
Depreciation	589,942	198,337	391,605
Extraordinary Retirement	0	0	0
Taxes Other Than Income	464,537	155,787	308,750
Income Taxes - Federal	(93,707)	(29,958)	(63,749)
Income Taxes - State	(23,876)	(7,633)	(16,243)
Amortization of ITC	(8,852)	(2,631)	(6,221)
Amortization of CIAC	(252,590)	(72,649)	(179,941)
<u>Total</u>	<u>675,454</u>	<u>241,253</u>	<u>434,201</u>
<u>Total Operating Expenses</u>	<u>4,753,778</u>	<u>1,281,206</u>	<u>3,472,572</u>
<u>Net Operating Income</u>	<u>890,912</u>	<u>556,939</u>	<u>333,973</u>
Interest During Construction	(17,756)	(5,277)	(12,479)
Interest on Debt	735,428	219,188	516,240
<u>Net Income</u>	<u>173,240</u>	<u>343,028</u>	<u>(169,788)</u>

Carolina Water Service, Inc.
Balance Sheet
June 30, 2004

<u>Assets</u>			
Plant In Service			
Water	11,532,256		
Sewer	<u>25,574,791</u>		
Total		37,107,047	
Accumulated Depreciation - Water	(1,925,249)		
Accumulated Depreciation - Sewer	<u>(2,856,648)</u>		
Total		<u>(4,781,897)</u>	
Net Utility Plant			32,325,150
Plant Acquisition Adjustment - Water	(217,337)		
Plant Acquisition Adjustment - Sewer	<u>(265,382)</u>		
Total			(482,719)
Construction Work In Process - Water	2,402		
Construction Work In Process - Sewer	<u>431,762</u>		
Total			434,164
Current Assets			
Cash	849,097		
Accounts Receivable - Net	921,816		
Other Current Assets	<u>12,676</u>		
Total			1,783,589
Deferred Charges			58,211
	<u>Total Assets</u>		<u>34,118,395</u>
<u>Liabilities and Other Credits</u>			
Capital Stock and Retained Earnings			
Common Stock and Paid In Capital	6,721,566		
Retained Earnings	<u>6,519,439</u>		
Total			13,241,005
Current and Accrued Liabilities			
Accounts Payable - Trade	106,053		
Taxes Accrued	58,445		
Customer Deposits	183,354		
Customer Deposits - Interest	245,763		
A/P - Associated Companies	<u>3,279,453</u>		
Total			3,873,068
Advances In Aid of Construction			
Water	800		
Sewer	<u>800</u>		
Total			1,600
Contributions In Aid of Construction			
Water	4,470,535		
Sewer	<u>10,724,811</u>		
Total			15,195,346
Accumulated Deferred Income Tax			
Unamortized ITC	285,286		
Deferred Tax - Federal	1,597,390		
Deferred Tax - State	<u>(75,300)</u>		
Total			1,807,376
	<u>Total Liabilities and Other Credits</u>		<u>34,118,395</u>